STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

DRAFT

Date Amended:	**02/28/05**	Bill No:	**AB 80**
Tax:	**Sales and Use**	Author:	**Houston**
Related Bills:	**AB 344 (Villines)** **AB 845 (Ridley-Thomas)** **AB 1580 (Torrico)** **SB 552 (Alquist)** **SB 631 (Dutton)**		

BILL SUMMARY

This bill would provide, effective January 1, 2004, a state sales and use tax exemption for purchases of qualifying tangible personal property by qualified persons primarily engaged in manufacturing, telecommunications and electrical generation activities, as specified. For purchases made after 1/1/04, but before the enactment of this measure, the bill would authorize qualified persons to file a claim for refund with the Board for the sales or use tax paid on the acquisition of the qualifying tangible personal property.

Summary of Amendments

The amendments add persons primarily engaged in electrical generation activities for commercial use within the scope of the proposed exemption.

ANALYSIS

Current Law

Under current law, entities engaged in activities such as manufacturing, research and development, telecommunications, and power generation activities that make purchases of equipment and other supplies for use in the conduct of their activities are required to pay tax on their purchases to the same extent as any other person either engaged in business in California or not so engaged. Current law does not provide special tax treatment for these entities.

Proposed Law

This bill would add Section 6377 to the Sales and Use Tax Law to provide an exemption beginning January 1, 2004 for the following purchases by a “qualified person”:

- Tangible personal property to be used 50 percent or more in any stage of manufacturing, processing, refining, fabricating, or recycling of property (i.e., machinery, equipment belts, shafts, computers, software, pollution control equipment, buildings and foundations).

- Tangible personal property purchased for use in research and development.
- Tangible personal property purchased by a contractor or a subcontractor for use in a construction contract for a manufacturer for use in manufacturing, processing, refining, fabricating, recycling, or as a research or storage facility.
- Tangible personal property purchased to be used 50 percent or more in maintaining, repairing, measuring, or testing any exempt manufacturing equipment.
- Tangible personal property purchased to be used in the telecommunication industry.
- Tangible personal property purchased for use by a contractor, as specified, for use in the performance of a construction contract for the qualified person who will use that property as an integral part of the manufacturing process, as described.

The bill would define a "qualified person" as any person primarily engaged in manufacturing activities, as described in the North American Industry Classification System Manual (NAICS) Sector 31-33, telecommunications activities as described in NAICS Sector 513310 through 513390, and electrical generation activities, for commercial use, that are described in NAICS Codes 22111 through 221122.

The bill would specify that the proposed exemption would *not* include 1) any tangible personal property that is used primarily in administration, general management or marketing, 2) consumables with a normal useful life of less than one year, except for fuels used in the manufacturing process, and 3) furniture, inventory, equipment used in the extraction process, or equipment used to store finished products that have completed the manufacturing process.

The bill would provide that, for purchases made in 2004, or in 2005 prior to enactment of this measure, a qualified person may file a claim for refund equal to the sales or use tax paid on the qualifying property.

As a tax levy, the bill would become effective immediately upon enactment.

Background

For a ten-year period ending December 31, 2003, the law provided a state sales and use tax exemption for purchases of equipment and machinery by new manufacturers, and income and corporation tax credits for existing manufacturers' investments (MIC) in equipment. Manufacturers were defined in terms of specific federal "Standard Industrial Classification" (SIC) codes. The exemption provided a state tax portion exemption for sales and purchases of qualifying property, and the income tax credit was equal to 6% of the amount paid for qualified property placed in service in California. Qualified property essentially was depreciable equipment used primarily for manufacturing, refining, processing, fabricating or recycling; for research and development; for maintenance, repair, measurement or testing of qualified property; and for pollution control meeting state or federal standards. Certain special purpose buildings were included as "qualified property."

This sales and use tax exemption and income tax credit had a conditional sunset date. They were to sunset in any year following a year when manufacturing employment (as determined by EDD) did not exceed January 1, 1994 manufacturing employment by more than 100,000. On January 1, 2003, manufacturing employment (less aerospace) did not exceed the 1994 employment number by more than 100,000 (indeed, it was LESS than the 1994 number by over 10,000), and therefore the MIC and partial sales tax exemption sunsetted at the end of 2003.

The manufacturer's sales and use tax partial exemption for new manufacturers and the corresponding income tax credit for existing manufacturers were added in 1994 by SB 671 (Stats. 1993, Ch. 881). The purpose of that legislation was to enable California to become competitive with the 42 other states that exempted manufacturing equipment and were luring manufacturers away from California with promises of lower taxes. SB 671 was designed to provide California companies with an immediate incentive to expand their facilities and to create new jobs.

In an October 2002 report put out by the Legislative Analyst's Office, *An Overview of California's Manufacturers' Investment Credit*, the following arguments against and in support of these tax incentives were presented:

Arguments Supporting the MIC

- Investment Incentive—The MIC effectively reduces the price of new capital, and leads to greater investment. Adherents of this view suggest that a firm considering a capital investment is much more likely to undertake such investment with the MIC in place. Proponents argue that this marginal cost reduction can have a significant positive impact on investment decisions.
- Relocation Incentive—California has become a more attractive place relative to other states for business since the credit has been in place. The argument here is that tax credits do influence corporate location decisions and dissuade businesses from moving their activities out of California. Manufacturing industry representatives stated and continue to state that the MIC plays an important role in both expansion and business location decisions.
- Efficient Job Allocator—Competition for business among states is an efficient job allocator. This argument holds that the nation benefits from the redistribution of jobs that may occur due to the use of investment tax credits. This is based on the notion that jobs are worth more in areas with higher unemployment, and that such areas are likely to have relatively aggressive tax credit programs. These areas will be able to attract businesses away from regions that do not value the jobs as highly.

- Other Arguments. Advocates of the MIC also emphasize that the MIC offers significant indirect benefits to the state in terms of investment and job growth that result in additional state revenues. They also point out the importance of manufacturing to the overall state economy in terms of economic stability and the high value-added nature of the employment in this sector.

Arguments Against the MIC

- Inequitable Taxation—The MIC results in giving a tax advantage to manufacturing over other business activities, as well as providing an advantage to capital investment over labor. This view holds that since only one type of industry (and production factor) benefits from the tax credit, the remaining industries face relatively higher costs, and are therefore at a competitive disadvantage. Such preferential treatment can also result in inefficient resource allocation according to this view.
- Relocation Rather Than Creation—The MIC results in few new jobs, but rather pits states against each other in competing for jobs. The argument here is that corporate tax breaks are no more than a transfer of government funds to private businesses, and in the end, the national economy is unaffected. In this view the competition among states in offering various tax incentives represents a form of "prisoners' dilemma"—in which each state would be better off if none offered such incentives. If one state does offer them, however, it is in the interest of other states to do the same.
- Inefficient Development Policy—Tax incentives have a negligible impact on economic growth, and any job creation that does occur does so at a substantial cost per job. Proponents of this view also hold that some of the tax credits will go to companies which would have made the same investments, regardless of the tax incentive. That is, the tax credit did not induce the investment, yet the company receives "windfall benefits" in the form of reduced taxes.
- Ineffective Development Policy—Taxes are a very small percentage of overall business costs and thus have little effect on business decisions. Labor, transportation, land, and other factors typically constitute much more significant proportions of total costs than do taxes. Therefore, according to those who hold this view, tinkering with this particular cost is unlikely to result in a large shift or expansion of business compared to the adverse fiscal effects that such measures can have on the state.

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the American Electronics Association. According to the author's office, its purpose is to make permanent the tax incentives available to manufacturers and telecommunications entities.
2. **The February 28, 2005 amendments** add persons engaged in electrical generation activities for commercial use within the scope of the exemption.
3. **Sales tax refunds are generally allowed only to persons who actually paid the tax to the Board.** Current law provides that an overpayment of sales tax to the Board shall only be refunded or credited by the Board to the person who actually paid the tax to the state. Therefore, if a customer paid sales tax to a retailer on an amount which should not have been subject to the tax, or paid sales tax in excess of the amount of tax due, the law provides that such an overpayment can only be claimed by the retailer who actually paid the tax to the state. The refund is issued by the Board directly to the retailer, with the condition that the refund be passed on by the retailer to the person from whom the tax was collected. Generally, the Board has no authority to refund the sales tax to someone other than the person who paid the tax to the state.

   There is a practical reason why the law prohibits a person who has not paid the sales tax to the Board to claim a refund directly from the Board. It ensures a safeguard against the possibility of issuing a tax refund twice on the same transaction. Without this safeguard, the opportunity for both the retailer and the person who paid tax to the retailer to file a claim for refund would be available, thereby increasing the possibility of duplicate refunds being issued. As drafted, this measure would deviate from this safeguard by enabling either the purchaser or retailer to claim a refund.
4. **Many telecommunication companies may not be currently registered with the Board.** The bill references NAICS Codes 513310 through 513390 for purposes of identifying the telecommunication entities that would be included within the proposed exemption. These entities include not only the typical telecommunications companies, such long distance carriers, cellular phone carriers, etc., but also those primarily engaged in such activities as paging services, earth stations for satellite communication carriers, resellers of satellite telecommunications, ship-to-shore broadcasting communications carriers, microwave telecommunications resellers, and others. Many of these entities may not be registered with the Board, since they are not engaged in the business of making sales of tangible goods.
5. **The bill would not reinstate the exemption for all manufacturers that qualified for the previous exemption.** This measure essentially reinstates the exemption that had previously been provided to manufacturers and broadens that exemption to include establishments other than new businesses and telecommunications entities. However, by defining qualifying establishments by reference to specified NAICS codes, rather than SIC codes referenced in former Section 6377, some

manufacturers that had qualified for the exemption prior to January 1, 2004 would not qualify for the exemption provided in this bill. For example, the logging industry is classified under the manufacturing group under the SIC code, but not the NAICS; publishers, as well, were classified under the SIC manufacturing codes, but not the NAICS. So, these two industries would not qualify for the exemption proposed in this bill. Other industries that had qualified but wouldn't under this bill because of the switch to NAICS would include those engaged in the production of industrial inorganic chemicals, miscellaneous nonmetallic mineral products, household audio and video equipment, aircraft and parts, ship and boat building and repairing, and guided missiles space vehicles and parts.

6. **Technical issues.** Subdivision (h) provides for an exemption from tax for specified leases of qualified property and limits this exemption for a six-year period. This limitation is modeled after a provision in former Section 6377 that provided a state tax exemption solely to *new* manufacturers' leases of equipment. Since this bill would provide the exemption for all qualifying manufacturers (and telecommunications entities), it appears the limitation in subdivision (h) is unnecessary and should be stricken. Otherwise, long-term leases of qualifying property would not enjoy the same tax privileges that the bill would provide to actual purchases of the same property.

   Although the Board administered the previous exemption for a 10-year period, some ambiguities in the statute caused confusion and perhaps should be addressed with the enactment of this measure. For example, the bill lacks a definition for the word "primarily" as it is used in proposed Section 6377(c)(6). The definition for "primarily" provided in proposed Section 6377(c)(3) only address the issue of when property is primarily used in a specific activity. It does not address the issue of whether the person claiming the exemption (i.e., the taxpayer) is primarily engaged in the required activities. This is an important issue and one that generated a lot of disputes when the Board administered Section 6377 previously. The following amendments to paragraph (3) of subdivision (c) of proposed Section 6377 to address this issue is recommended

   > 6377(c)(3) "Primarily" as used in subdivisions (a) or (b) means tangible personal property used 50 percent or more of the time in an activity described in those subdivisions ~~subdivision (a)~~. "Primarily" as used in subdivision (c) means the qualfying person is engaged in the activities described in that subdivision 50 percent or more of the time.

   Another issue relates to the proposed definitions for the types of property included or excluded from the proposed exemption. For example, on lines 23-24 and 36-37 on page 4, the bill refers to the items having a useful life of one year or more (or less). In order to lessen potential audit disputes, the bill should contain some mechanism for determining the useful life. Perhaps some reference to the provision in the California income tax laws for depreciating assets should be incorporated into the bill.

On line 35, "or the Franchise Tax Board" should be added after "board" since use tax can also be self-reported on the returns filed with the Franchise Tax Board.

The bill would require claimants to include, among other things, copies of their invoices or purchase contracts to document their claims for refund. This could be cumbersome, especially with large manufacturers or telecommunications operators who may have a large number of qualifying purchases during 2004 and 2005. A preferable approach would be to require the claimants to simply retain documentation for purposes of verification of claimed amounts.

7. **Related measures.** Other measures that would provide an exemption for manufacturing activities and other related activities include:

- AB 344 (Villines) would state legislative intent to reinstate the exemption and credit previously provided to manufacturers.
- AB 845 (Ridley-Thomas) would reinstate the manufacturer's exemption but provide a conditional sunset date depending on the growth in employment and limit the exemption based on the manufacturers' aggregate gross assets. AB 845 would also include manufacturers other than new establishments.
- AB 1580 (Torrico) would declare the intent of the Legislature to exempt from sales and use tax, sales and purchases of manufacturing equipment and telecommunication equipment used in the manufacturing process.
- SB 552 (Alquist) would provide a state and local sales and use tax exemption for purchases of materials, supplies, machinery and equipment used by entities engaged in manufacturing, research and development, and telecommunications, but would provide that, beginning on January 1, 2006, taxpayers would be able to accrue credits on their purchases that may be redeemed during the first fiscal year of the state budget when state revenues match expenditures.
- SB 631 (Dutton) would reinstate the manufacturers' exemption and income tax credit, and would broaden that exemption to include purchases of equipment by electrical generators.

COST ESTIMATE

The Board would incur costs to administer this measure. These costs would be attributable to, among other things, processing and reviewing claims for refund, identifying and notifying qualifying entities, auditing claimed amounts, revising sales tax returns, and programming. An estimate of these costs is pending.

REVENUE ESTIMATE

Background, Methodology, and Assumptions

This bill would exempt from the state sales and use tax sales and purchases of equipment by businesses described in Codes 31 to 33; on telecommunications equipment purchases by businesses described in Codes 513310 to 513390; and on electrical generation equipment purchases by businesses described in Codes 22111 to 221122, all inclusive of the North American Industry Classification System Manual (NAICS) beginning January 1, 2004. Estimated purchases of qualified equipment as defined in this measure are estimated as follows:

Year: 2004

NAICS Code	Classification	Equipment Expenditures
31 to 33	Manufacturing	$ 13.6 billion
513310 to 513390	Telecommunications	$ 5.4 billion
2211-22	Electrical Generation	$ 2.9 billion
Total		$ 21.9 billion

Year: 2005

NAICS Code	Classification	Equipment Expenditures
31 to 33	Manufacturing	$ 13.9 billion
513310 to 513390	Telecommunications	$ 5.5 billion
2211-22	Electrical Generation	$ 3.0 billion
Total		$ 22.4 billion

FY Ending: 2006
(6 mos.)

NAICS Code	Classification	Equipment Expenditures
31 to 33	Manufacturing	$ 7.1 billion
513310 to 513390	Telecommunications	$ 2.8 billion
2211-22	Electrical Generation	$ 1.5 billion
Total		$ 11.4 billion

Revenue Summary

If we assume that claims for refund for tax paid on qualifying equipment for the period January 1, 2004 through December 31, 2005 are all filed and approved during fiscal year 2005-06, the revenue loss would be as follows (assuming a 2% annual increase in expenditures):

FY Year	Rate	Expenditure	Revenue Loss
05-06	State (5.206%)*	$55.7 billion	$2.90 billion
06-07	State (5.25%)	$23.3 billion	$1.22 billion
07-08	State (5.25%)	$23.7 billion	$1.24 billion

*For 2004, the rate changed July 1 to 5.25 percent. Therefore, the loss is computed for six months at 5.00 percent and 18 months at 5.25 percent, or an average rate of 5.206 percent.

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